

## MOODY'S ASSIGNS Aa3 RATING TO STATE OF CALIFORNIA GO BONDS

NEW YORK, Sep 9, 1999 -- Moody's has assigned a rating of Aa3 to the general obligation bonds of the State of California. The rating reflects the state's deep, diverse and growing economic base and its vastly improved financial condition, including the rebuilding of cash and budget reserves, and increased attention to debt management issues. These strengths are offset by a historic pattern of revenue volatility, and significant infrastructure needs, the funding of which will likely weaken the state's moderate debt position. The credit outlook is stable.

These general obligation bonds were authorized by the voters in November 1998 through the adoption of Proposition 1A, the Class Size Reduction Kindergarten-University Public Education Facilities Bond Act of 1998. The \$9.2 billion bond authorization will provide funding to facilitate class size reductions, to relieve existing overcrowding conditions, accommodate projected student enrollment growth, and to repair older schools. These bonds are being issued to retire state general obligation commercial paper notes which were issued to finance various K-12 educational facilities and costs of program operation.

The Aa3 rating is based on the following credit considerations.

### STATE ECONOMIC GROWTH PROJECTED TO CONTINUE TO OUTPACE NATION

Over the last three years, the state has enjoyed healthy gains in both employment and personal income, comfortably outpacing the nation's growth as measured by these two economic indicators. Such growth has been realized despite the adverse effects the Asian recession has had on state exports over the last two years. While the economic weakening of the Pacific Rim contributed to employment declines in high-tech manufacturing in the state, these job losses were more than offset by continued growth in the services, construction and tourism industries. The economy's increased diversification has positioned it for further expansion in the near term, but the state has projected growth that will likely be at a slower pace than that realized over the last two years. The state's tempered economic assumptions, used to develop the revenue estimates for the May Revision budget proposal, compare favorably to other leading regional economic forecasts such as the LAO, Western Blue Chip and the UCLA Anderson Forecast.

Moody's anticipates the state's economy will continue to outperform the nation over the next two years. Given the fact that most economists agree the Asian recession has "bottomed out", there is upside potential for the state's revenue forecast. Consistent with consensus economic forecasts, the state's economic projections do not assume a significant rebound in the Asian economies in the near term. Any gains above the marginal growth anticipated in this region would undoubtedly have a beneficial impact on state exports, and would lead to increased employment growth for the state beyond current forecasts.

### STRONG CASH POSITION PROVIDES BUFFER AGAINST REVENUE VOLATILITY

The state ended fiscal 1999 with total borrowable resources of \$8.7 billion, including a \$1.255 billion balance in its Special Fund for Economic Uncertainties (SFEU). Combined with an ending general fund cash balance of nearly \$850 million, the \$9.6 billion in available resources is the most the state has had on hand in over two decades. These sizable balances provide a buffer against the state's historic revenue volatility, a product of its economically sensitive tax structure. As a result of its strong cash position, the state anticipates a cash flow borrowing of only \$1 billion in the current fiscal year, its smallest annual short-term cash flow borrowing since the early 1980's. After paying off the projected \$1 billion cash flow borrowing, the state anticipates it will close the current fiscal year with unused borrowable resources of approximately \$6.5 billion, including a SFEU balance of \$880 million. The state's current financial condition is sufficiently resilient to weather a mild national recession without undue stress, but a harsh or regionally concentrated state recession - while considered unlikely - could produce a liquidity strain similar to those experienced in the early 1990's.

### FISCAL 2000 BUDGET CALLS FOR 9% REVENUE AND EXPENDITURE GROWTH

The California State Budget was signed into law on June 29, 1999, the first time in seven years that the state has been able to reach agreement on the fiscal year budget prior to the state's constitutional deadline. Reflecting improved revenue performance, the \$81.3 billion budget differs greatly from Governor Gray Davis' inaugural budget

submission to the legislature. The original budget proposal assumed tax revenue collections in fiscal 1999 would be moderately weaker than originally anticipated in the fiscal 1999 budget. This pessimistic revenue projection was based on a Fall 1998 projection that the Asian recession would result in a slowdown in economic growth in the state, and a projected slowing of the U.S. economy as well. However, based on tax collections through April and the state's continued economic growth through the 1st quarter of 1999, it became clear the Asian recession had not had as great an adverse effect on the state's economy as expected. In addition, the U.S. economy continued to outperform even the most optimistic of economic growth forecasts. As a result, the governor's May Revision budget proposal revised the state budget revenue forecast by \$1.6 billion in fiscal 1999 and \$2.7 billion in fiscal 2000.

Based on the state's unexpectedly strong economic and revenue performance, the fiscal 2000 budget assumes general fund expenditure growth of nearly 9% over preliminary 1999 actuals. The state's revised revenue projections enabled the state to, among other things, increase K-12 education funding, increase the level of its reserve to approximately \$900 million, and to provide a one-time 10% reduction in the state's motor vehicle license fee. However, the adopted budget did not include any type of mid-year correction mechanism as proposed by the governor that would have allowed the state's director of finance to revise the budget if revenue collections fell below budgetary forecasts. The state's strong economy and fund balance levels account for the lack of legislative support for this mechanism at this time.

## Y2K RENOVATIONS ARE CONTINUING

As part of its Y2K remediation effort, the state identified 556 state systems as "mission critical", defined as those systems which encompass public safety, public health, and financial and personnel aspects of government services. Based on a survey of all state departments conducted by the state's Department of Information Technology, 97% of the state's mission critical systems have completed remediation. The state anticipates all mission critical systems will be Y2K compliant by the end of September, as will all contingency plans.

The state's remediation effort is estimated to cost \$357 million, all of which has been appropriated by the General Assembly. And during the 1998 legislative session, state lawmakers adopted a bill which provides immunity from tort liability for any person or entity, including government entities, who shares information about the Year 2000 in good faith. For additional commentary on the potential effects of the Year 2000 computer problem on states and other public finance issuers, please see a Moody's special comment on this topic, "Y2K Credit Risk Implications for the US Public Finance Sector", dated March 1999.

## FUTURE CAPITAL NEEDS LIKELY TO INCREASE ABOVE-AVERAGE DEBT BURDEN, HIGHLIGHTING NEED FOR MULTI-YEAR CAPITAL PLANNING PROCESS

The state's economic and financial improvement over the last several years, and the moderation of debt issuance for prison construction, have led to an improvement in its debt ratios. But while these ratios have improved, they are still above the national medians, with net tax-supported debt per capita and debt as a percentage of personal income ranking 17th and 19th, respectively.

In 1998, the Department of Finance identified \$80 billion in infrastructure needs for the state over the next ten years. Such needs primarily involve the rehabilitation and enhancement of California roads, schools, prisons, water and sewer systems, parks and public office buildings. While a significant portion of these investments will be federally funded, the state will be required to issue a significant amount of debt to fully fund its current and future needs. These debt issuances are likely to increase the state's above-average debt ratios beyond current levels.

The State Treasurer is statutorily required to annually submit a debt affordability report to the governor and state legislature, providing an analysis of the state's debt position and debt capacity. This report must be submitted no later than October 1 of each year. In June 1999, the treasurer released a special update to the report which, among other things, included a projection of how much debt the state could "afford" over the next ten years given certain revenue and expenditure growth assumptions. The report was released during the current legislative session to assist the governor and legislature in their capital planning decisions as the legislature debates several bonding measures.

Currently, debt service represents approximately 4.2% of state general fund revenues. The treasurer's report illustrates that if revenues and expenditures annually grow in tandem at a rate of 5.5% over the next ten years, the state could assume an additional \$32.5 billion in debt during this period without exceeding the 4.2% targeted ratio. However, as pointed out in the report, the state's long-term debt capacity is strongly affected by general fund revenue volatility. If revenue growth is one percentage point less than the projected 5.5%, then the state's debt capacity for the ten-year period decreases to approximately \$5 billion.

The potential for such swings in debt capacity and the scale of capital needs facing the state highlight the need for the state to adopt a multi-year capital planning process. Such a formal process would enable the state to adequately address its long-term infrastructure needs without limiting budgetary flexibility, especially during a period(s) of weakening economic and revenue performance.

## **OUTLOOK:**

The rating outlook for the state is stable. The economy is projected to continue to grow, but at a slower rate than that of the last two years. However, such growth should continue to outpace that of the nation. Given the scale of capital needs, the debt burden is likely to grow, further highlighting the state's need to pursue its new plans to institute a formal multi-year capital planning process to maintain the integrity of the state's infrastructure.

## **DEBT AFFECTED:**

ISSUE	RATING
General Obligation Bonds	Aa3
<b>Sale Amount</b> \$400,000,000.00	
<b>Expected Sale Date</b> 09/13/99	
<b>Rating Description</b> General Obligation Bonds	

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